

# EVALUATION OF INVENTORIES ACCORDING TO THE STANDARDS OF ACCOUNTING

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## Abstract

The realization of the economic enterprise of every economic unit is a complex problem and a result of the cooperation of many factors of social and material character. In addition to the use with effectiveness of the material and technical basis which form the long term assets which the economic unit has at its disposal, before and during its functional process, a special importance but also important take also the long term assets among which are the inventories. The process of inventory valuation is important for the economic unit, to ensure a real presentation of financial review. For this condition to be met a very important element is the implementation of the National Standards of Accounting. The valuation of inventories according to SKK is related with the selection of basic methods which will be used for their valuation.

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## Understanding and introduction of inventories

The term inventory is referred to goods or materials used by a company for the purpose of production and sales. It also includes the items which are being used as contributory to facilitate the production.

The inventories take part in the short term material activity and which satisfy the conditions of being classified as such. They are elements of the property of the economic unit, of non-monetary and non-financial nature and which have a material nature which are standardized in a given physical form and cannot be identified. Therefore the short term material assets are those economic resources controlled by the economic unit, as a result of the past events and from which the unit expects to receive benefits in the future.

The economic unit will acknowledge an element as a short term material asset when if:

- *It satisfies the conditions of being a short term material asset,*
- *It is capable to define the value of this asset precisely and in a credible way*

Usually the short term material assets are known with the term “Inventories”. According to the general valuation made by the standards of accounting, inventories are those assets of the economic unit which satisfy the following conditions:

- Are being kept by the economic unit to be sold, in the usual course of the business,
- They are in the process of production, of inventories for sale, in the form of the materials or supplies to be consumed in the process of production of products for sale, or in the process of performing the services.

Therefore the non financial material assets represent *expenses unperformed and not included yet in the result of the unit for a period of time, but which will emerge as such and will produce profit in the future periods of the activity of the economic unit.* (They are in the form of materials or expenses to be delivered).

The problems which the accounting should solve in relation with this group of assets are those related to their classification, their calculation in the date of their inclusion to the balance as well as the determination of the part which will be included in the result of every *accounting* period, during which they will be used.

The most important problem of accounting in relation with the material assets is the implementation of the *principle of collation* in relation to them. According to this principle, part of these assets which will pass in the form of the cost, in the calculation of expenses of the respective accounting period, must needs registered within this period, because this period will be the period in which this part gives the economic profit, therefore it brings the provision of the profit.

#### **The classification of inventories.**

For the need of the organization of the accounting evidence, inventories are being classified into some main groups:

- Raw materials and materials (synthetic account 31);
- Goods for resale (synthetic account 35);
- Ready products for resale (synthetic account 34);
- Half ready products and production in process (synthetic account 33);

- Biological short term assets (synthetic account 36);
- Objects of inventory, detailed inventory and packaging (synthetic account 32);

### **Organization of accounting evidence.**

In order to represent the condition and the movement of the inventories according to their type in accounting, synthetic calculations are opened for each of the given groups, in which their classification is treated, such as: raw materials, materials, goods for resale, half ready products, half products, production and services in process, detailed inventory, packaging, etc. in order to have a more concrete and analytical information, which enables: protection, administration and decisions related with inventories, in accounting are also opened *analytical calculations* for each of the types of the inventories within each group, the entirety of which forms *the helping books of the inventories*. A special characteristic of the inventories is the fact that they provide not only valuable information but also quantitative for each of them. For instance, if in the charge account for resale we have some items, for each of them will be opened analytical account and each of them will provide information for the quantity and value. For inventories should be implemented the rules of *the interior control* taking into account the great risks that associate their administration. The person in charge in relation with the administration of the inventories, usually called the warehouseman, should keep daily registering concerning the circumstance, inflow and outflow of the inventories. For this reason, the warehouseman keeps the cartels of the warehouse in the form of a book or special cartels. For every inflow or outflow of the inventories from the warehouse, the warehouseman will make the respective justifying accounting document, check-in certificate for the entries and release document for the exits (or sale invoice), which in the end of the day he should represent by registering them only in quantity, in the respective cartels of every item of the inventory. The original copies of the check-in document and release document of the warehouse should be delivered officially in the office of accounting. In order to verify the verity of the data of accounting with those factual ones it is necessary to be performed *their physical stocktaking at least once per year. The date of the performance of the physical stocktaking should be the date of the end of the reporting year or another date, close to it before or after it.*

The condition of each kind of inventory according to the physical stocktaking should be the same with the condition of the inventories in value and the same with the condition of the inventories in quantity according to the books of the warehouse kept by the warehouseman. If there are differences they should be investigated to find the cause. If for them the responsibility falls upon the warehouseman then he should be held responsible for

them. The organization of the accounting evidence is determined also by the accounting method which is being used. In the economic unit uses the method of *the continuous stocktaking*, then it should open synthetic accounts in the financial accounting and analytical account for each of the items in the inventory. In these accounts will be registered all the entries and exits of the inventory from their storage place in the economic unit. If the economic unit keeps the accounting evidence of *the periodical stocktaking*, then the economic unit should keep only synthetic account in the financial accounting for the whole inventory or each of its main groups. In order that the inventories are effective and well administered, the economic unit organizes *the analytical accounting* of the inventories, which provides the whole information for each inventory in relation with the initial overstock, their entries and exits.

*Reconciliation* of the records of financial accounting with those of the warehouse is performed only if the accounting evidence is kept according to the method of the continuous inventory. Whereas the accounting evidence of the inventory is kept according to the method of periodical stocktaking. Reconciliation of the records in accordance with the inventory is made with the records of analytical accounting of the inventories.

### **Estimation of inventories according to the standards of accounting**

According to the description of inventories in SNK 2 but also in SKK 4, we shall distinguish three moments of estimation of inventories:

**Estimation in receipt;**

**Estimation in exit; and**

**Estimation in the date of accounting balance;**

### **Estimation of inventories in entry.**

Estimation of inventories in entry is conditioned by the way of their entry in the economic unit. Inventories enter in the economic unit when:

1. Purchased by the third party.
2. Taken in exchange of another asset or interests in capital.
3. Taken for free.
4. Produced by the economic unit itself.

**The general principle of the estimation** of the inventory in entry is with the cost of insurance, which is equal with: costs of purchase, costs of processing and other normal costs.

### **Estimation of inventories purchased by the third party.**

Inventories which are purchased by the third party are estimated in entry with the cost of purchasing. In the cost of purchasing of inventories are included all the expenses made

until the inventory be available at the economic unit to be used for the purpose for which it has acquired it. These expenses include: price of purchasing by the suppliers, costs of transport to the place of their use or storage, non-refundable taxes and revenues, costs of management of their purchasing and similar expenses. If during the purchase are applied discounts or retail mark-ups they are discounted during the calculation of cost of the purchased inventory.

**If for the purchase of the inventory the economic unit takes a loan** and if the process of purchase is long, usually when it is involved into two accounting periods, then in the cost of the purchasing of the inventory may be included the interest of loan.

**If the inventory is purchased with foreign currency** then in the cost of purchase can be included also the difference from the exchange rate that results during the process of its purchasing. The inventory purchased in foreign currency will be presented registered in accounting expressed in the reporting currency (in money) converted with the exchange rate of the date of the action of purchasing.

#### **Estimation of the inventory produced by the economic unit (ready products)**

The estimation of the inventory which is being produced by the economic unit (ready products) are estimated with **the cost of production** which includes

- a. **Direct cost** of their production (i.e. the direct cost of materials and the direct work) as well as
- b. **Direct cost of production** which is related directly or indirectly with the production of the inventory.

When the economic unit produces simultaneously some products (**co-products**) and the cost of each cannot be highlighted directly, then the cost of the total production of all the inventories will be delivered among the produced products by using certain methods of delivery, such as: based on the produced amounts or on the realized gains, etc.

#### **Estimation of inventories taken in exchange of an asset or capital interest**

Inventories taken in exchange of an asset or capital interest are estimated as follows:

When inventories are taken in exchange of a similar asset, their value is equal with **the direct value of the asset given in exchange.**

If the right value of the given inventory cannot be determined, the nit will be estimated with the right value of the taken inventory.

**The right value is the price**, by the means of which an asset twill be exchanged or a liability is liquidated among the well informed parties, willing and unrelated with each-other.

-When there is active market for the received inventory, as a right value is the market value in the moment of exchange.

**The market value** is determined as the amount of money which can be taken by the sale in an active market.

-When there is no market for the inventory taken the right value of the given inventory is used.

-When there is not active market for none of the inventories, the right value of other similar inventories is used.

**When the inventory is taken as a contribution in nature of the owner**, then it will be estimated with the value of the survey, which are usually based on the values of market or will be estimated with the right value of the shares of the capital given in exchange.

#### **Estimation of inventories when they are taken from state subsidies or donations**

As a cost for the inventories taken from state subsidies or donations, will be their value right value in this moment, or the possible value of their use, or the right value of the similar inventory.

#### **Treatment of some other expenses.**

a) If during the entry of inventories *also other costs* occur, which are not mentioned above, they will be included in the cost of entry of inventories only in the size they occur for bringing of inventories in the place and actual conditions. For example, if the economic unit purchases an amount of sugar in bags and packages it for sale, then the costs of packaging will be part of the initial cost of sugar.

**b) Are not included in the cost of inventories in the moment of their receiving, but are included in the cost of the period:**

- Non normal amounts of spent materials, work and other costs of production.
- Costs of storage if these costs are not necessary in the process of production before the further phase of production.
- General administrative expenses which do not contribute in the bringing of inventories in the place and actual conditions.
- Costs of sales.

**Cost of the loan taken for** the production of inventories is usually not included in the cost of inventory. But when the production of inventories overpasses the period of 12 months, then the costs of the loan can be capitalized in the cost of the inventory. The cost of the loan in this case will be included in the cost of the inventory during the period which the process of

production lasts. In the moment that the inventory becomes ready, for the purpose for which it is being produced then the capitalization of the cost of inventory and the interests of the loan taken are interrupted, in the coming periods will be included in the expenses of the period when they are being purchased according to the principle of consistency of the expenses with the gains.

### **Estimation of issued inventories.**

Their precise valuation is of importance because it is included in the cost of the period and therefore it affects its result. The evaluation in exit is done with the cost of their purchase or with the cost of production. In those cases when *the cost does not change during the exercising period, is used the method of specific identification.*

Whereas, for inventories, the cost of purchase and the production of which changes during the exercising period, *bit is made a assumption on the series of the selling of inventories. (i.e. for the course of their cost).*

The estimation of inventories in exit can be done by valuating them according to two basic methods as follows: valuation with the average value and valuation with the method **F.I.F.O.**

### **Valuation of inventories with the method of average cost.**

Valuation of inventory exited for sale or for the process of production is conditioned by the method that the unit uses for measuring and highlighting the inventories in accounting, which means that the unit uses the method of continuous stocktaking or the method of periodic stocktaking. In the case when the unit uses the method of continuous **stocktaking** the inventory that exits is valuated step by step based on the amount exited and the average cost for unit of the exited inventory. The average cost is calculated as a simple average, as a weighted average in the end of the period or as a weighted average step by step of the purchased inventory, i.e. as a *slipping weighted average*. Today in the conditions of the use of technology of information in accounting it is determined as a *slipping weighted average cost*. The use of this method is facilitated by the applying programs used for the informatization of accounting. In the case when the economic unit for the measuring and highlighting of inventories uses the method of *periodic stocktaking*, the value of inventory exited is determined indirectly, as a difference between the value of the inventory valid for use and with the value of inventory in the end of the period. In this case firstly the value of the inventory in the end of period should be determined. For that it is necessary at first the performance of the physical inventory for the determination of the amount of actual inventory which will be evaluated. This amount is multiplied with the average value for inventory unit.

The average cost for unit is calculated by dividing the cost of the goods valid for sale with the units of inventories valid for use. According to this method the cost of the inventory in the end of the period is calculated as an average of costs of inventories in the beginning of the period and the inventory purchased during the period. The cost of the inventory exited (for sale or for production) is equal with the cost of inventory valid for unabated sale with the value of inventory in the end of the period. This method has an advantage because it is simple in relation to the calculation of the average cost. But on the other hand this method has as a disadvantage the effects of averaging, especially in the condition of the great wavering of the prices of inventories in the market.

### **Valuation of inventories with the method first in first out (FIFO) method**

According to this method it is supposed that the inventories are issued for sale or used for production according to the turn of their purchase, or taking in consideration the expire date of every inventory.

Therefore according to this assumption the stocks in the end of period will consist of the units of the purchased inventory in the end of the period, whereas the issued inventory will consist of the purchasing units in the beginning of the period. In the case when the unit uses the method of continued stocktaking the issued inventory would be evaluated indirectly after the valuation of inventory in the end of the period. This valuation is determined as a difference of the inventory valid for use with the value of inventory in the end of the period.

For the valuation of the inventory in the end of the period first its physical stocktaking to determine the actual amounts and later to make their valuation starting from the end and going straight, initially until such a thing is necessary. The method of valuation of the stock inventory in the end of the period with the method FIFO, in the conditions of inflation **gives the most possible lower value** of the cost of the issued inventory (of the KMSH or the cost of inventory used in production) and as a result the highest possible value of the stock inventory in the end of the period. In this way it has as a result the calculation of a bigger net income (because of the size of the gross gains which is calculated as a difference between net sales with the cost of the sold goods) as well as the most possible highest valuation of inventories represented in the balance. In the periods of the constant lowering of prices the opposite effect will happen. This is the reason that in many countries of the world the fiscal authorities demand or allow that the inventory position in the end of the period be evaluated according to this method. Considering that according to the method FIFO the inventory in the end of the period will be presented in the balance with the actual value, by giving in this way a more realistic view of the short term assets, is more appropriate by the point of view of the balance.



The choice of the method of the valuation of the position of inventory in the end of the period is a *accounting policy* which is made by the direction of each economic unit, aiming at a more precise and credible of the values of inventories. What is important is that the economic unit should implement from year to year the same method of valuation for the implementation of the principle of the stability of methods, to acquire qualitative information for decision-taking.

**When the inventories are issued**, the value they carry over valued as above should be acknowledged *as an expense of the period*, when the inventory brings the incomes, regardless of the fact when the money is taken or rights that emerge in relation with them. This value of the inventory valued as above for the trade units constitutes the cost of the sold goods, whereas in the producing units constitutes the cost of the direct materials used in the process of production.

**The valuation in the date of the accounting balance.**

The valuation of inventories in the closing of the exercising is made with the smallest value between the cost (accounting value) and feasible net value.

The feasible net value is the estimated price of sale in normal course of the reporting economic unit minus estimated costs of completion and sale.

**Inventories cannot be presented in the balance with a value bigger than VNR.**

**Other methods of the valuation of *inventory*.**

In addition to the valuation of the inventory by the means of the cost, there are other methods of valuation of the inventory, such as the valuation of the inventory with the market value, the valuation of the inventory with the method LCM, the valuation with the price of the sale, the method of gross profit etc, for which it is necessary to be acknowledge by the economic unit.

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